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TO RUEHC/SECSTATE WASHDC 6963  
RUEATRS/DEPT OF TREASURY WASHDC  
INFO RUEHXS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS  
RUCPDO/DEPT OF COMMERCE WASHDC  
RUEHKO/AMEMBASSY TOKYO 1077  
RUEHBJ/AMEMBASSY BEIJING 4458  
RUEHBY/AMEMBASSY CANBERRA 1513  
RUEHUL/AMEMBASSY SEOUL 4279  
RUEAIIA/CIA WASHDC

UNCLAS SECTION 01 OF 02 JAKARTA 003099

SIPDIS

SIPDIS  
SENSITIVE

DEPT FOR EAP/MTS AND EB/IFD/OMA  
TREASURY FOR IA-SETH SEARLS AND JWEEKS  
SINGAPORE FOR SBAKER  
TOKYO FOR MGREWE  
COMMERCE FOR 4430/BERLINGUETTE  
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN  
DEPARTMENT PASS EXIM BANK

E.O. 12598: N/A

TAGS: [EFIN](#) [EINV](#) [ECON](#) [PGOV](#) [ID](#)

SUBJECT: RESTRICTIONS ON FOREIGN PURCHASE OF BANK INDONESIA  
CERTIFICATES?

¶1. (SBU) Summary. Despite a modest retreat in the June-August period, gross capital inflows to Indonesia remain high and have accelerated in recent months. Concern about a sudden reversal of portfolio inflows prompted public comments from two Bank Indonesia (BI) officials as well as an internal debate on the desirability of foreign ownership of Bank Indonesia Certificates (SBIs). BI officials confirmed in meetings with the Embassy that it has no plans to restrict foreign ownership of SBIs or introduce capital controls in the near term. The SBI debate is part of BI's broader discussions on how to encourage longer-term portfolio investment in Indonesia. End Summary.

#### Capital Flows Continue to Increase

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¶2. (U) Despite a modest retreat in the June-August period, gross capital inflows to Indonesia remain high and have reaccelerated in recent months. Gross portfolio inflows totaled \$8.8 billion during the first half of 2007 compared to \$5.7 billion during the full year 2005 according to official Bank Indonesia balance of payments data. According to a recent report by Standard Chartered's team in Indonesia, the ratio of hot money (defined as debt flows and equity investments by portfolio managers with short-term investment horizons) to Indonesia's foreign exchange reserves has risen to 85% from 60% in 2005. BI data also reveals that foreign investors own 68% of the Jakarta Stock Exchange and account for 17% of total government bond ownership.

¶3. (U) The level of capital inflows has prompted comments from a number of high ranking officials in recent weeks that the current situation is reminiscent of the days leading up to the 1997-98 financial crisis. Other comparisons to the period preceding the 1997-98 crisis are less analogous. The Indonesian banking sector has significantly less short-term foreign currency exposure and a much healthier balance sheet. Indonesian investors have diversified their investment portfolios away from only Rupiah denominated investments and foreign exchange reserves are high, exceeding \$50 billion.

#### BI Debates Restricting Foreign Ownership of SBIs

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¶4. (U) Although equity markets were the most volatile asset class in the wake of global financial turmoil in August, SBIs have also proven vulnerable to changes in global financial market conditions. Foreign investment in SBIs was close to Rp 30 trillion (\$3.3 billion) prior to the onset of the sub-prime credit crisis. That number dropped quickly to Rp 12 trillion (\$1.3 billion) in August as investor risk aversion increased. (Note: The percentage of foreign ownership of SBIs was 12.2% in September 2007, a figure equal to proportion of SBIs owned by foreigners in December 2005.)

¶5. (U) The resurgence of capital inflows since August prompted public comments from two prominent BI officials as well as an internal debate on the desirability of foreign ownership of SBIs. On September 17, during his Parliamentary screening hearings, incoming Deputy Governor Budi Mulya stated that, foreign investors should be restricted from owning SBIs. He does not believe the presence of foreign investors in the SBI market benefits the central bank. He also stated that BI uses SBIs to absorb domestic liquidity. "If a foreign party has an SBI, than additional liquidity has entered the country," he said. On October 8, the Indonesian press reported that BI Deputy Governor Hartadi also expressed concern about the level of foreign ownership of SBIs given that BI never intended for the SBI to be used as an investment instrument.

¶6. (SBU) Experts close to BI assert that there are two schools of thought on foreign ownership of SBIs. On one side, in line with the public statements of the Deputy Governors, a number of BI officials have questioned the desirability of paying high rates of interest to short-term foreign investors on the instruments BI uses to conduct monetary policy. In addition, these officials are concerned that SBIs, which BI prices at a fixed rate, are acting as a magnet for hot money flows and introducing increased foreign exchange

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volatility. On the other side, officials, who also acknowledge that the central bank is paying a significant premium on SBIs to short-term investors, argue that the flow of short-term foreign funds into SBIs has reduced volatility in other Indonesian fixed income and equity instruments. Short-term foreign investors have been attracted to the 30-day SBI as it provides a relatively high rate of return for a liquid instrument.

¶7. (SBU) An International Monetary Fund (IMF) representative in Indonesia has discouraged BI from placing restriction on foreign purchases of SBIs given the negative signal such a move would give to the markets. The IMF has cautioned BI against making policy changes during periods of financial sector instability. Local bankers and capital markets experts have questioned the enforceability of such a move. Foreign investors would likely be able to work around the new rules by using local banks as agents. On the other hand, analysts in the region have also questioned the prudence of restricting foreign purchases of SBIs given the lack of comparable instruments in Indonesia. Since no good alternative investments are available, foreign restrictions on SBI purchase could lead to a significant outflow of funds in the short run, potentially destabilizing the Rupiah.

BI Unlikely to Impose Restrictions in Near Term  
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¶8. (SBU) Embassy meetings with BI officials indicate that the central bankers are aware of the problems associated with any restrictions on foreign ownership of SBIs. They noted BI has debated restricting foreign ownership of SBIs for many years, including the years preceding the 1997-98 crisis, and that this policy view currently has little support. BI officials maintain that they have no plans to introduce capital controls and will not make any policy changes without active consultations with the private sector. BI officials are also aware of the negative market signals and enforceability problems associated with any restrictions on foreign ownership of SBIs. At a September 29 press conference, Senior Deputy Governor Miranda Goeltom stated explicitly that there is no need or plan to restrict SBI foreign ownership or any short-term capital inflows. She warned against changing policies

every time a new development occurs in financial markets. She also pointed out that Indonesian capital markets need funds available to absorb additional issuances and help deepen markets.

#### BI Contemplates Policies to Deepen Capital Markets

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19. (SBU) The SBI debate is part of BI's broader discussions on how to encourage longer-term portfolio investment in Indonesia. (BI public communications are not always seamlessly coordinated.) BI bank has contemplated restricting foreign investment in SBIs recently as a means to redirect funds towards other assets in an attempt to deepen capital markets. BI is also considering a wide range of banking reforms to encourage banks to channel their resources toward capital market development. The Banking Research and Regulation Directorate at BI is leading discussions to permit banks to engage directly in capital markets activities under a universal banking model. The same BI unit is also contemplating policy incentives, e.g. easing minimum reserve requirements, to encourage banks to invest in corporate bonds. Finally, BI is considering relaxing some rules around off-balance-sheet positions in an effort to encourage banks to increase asset securitization and use of derivatives. Central bank officials note, however, that policy discussions around these issues are in an embryonic stage.

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